WILMINGTON TRUST

# DIVORCE INSIGHTS

Nine timely articles dealing with complex financial issues that result from divorce

An **eBook** for Professional Advisors

## A Trusted Resource for You

Hello, and thank you for your interest in reading insights from the Wilmington Trust leadership team about the complex financial issues created by divorce.

As a professional advisor, you are aware of the dilemmas faced by couples dissolving their marriages. They look to you as their trusted advisor.

You see your clients when the idea of divorce is new, and decisions are yet to be made. You are with them during the proceedings when couples are actively ironing out their new lives, dividing assets, and planning for separate futures. You can help them after the divorce decree is final and the lasting repercussions become reality.

Every day, I watch our financial professionals work with such clients, and we're committed to helping divorcees find, and reach, financial stability and freedom. High-net-worth clients often experience even more complex issues regarding the financial aspects of divorce.

That is precisely why we created a National Family Law Practice Group at Wilmington Trust. We handpicked a team of our professionals across disciplines, including investment advisors, trust advisors, wealth strategists, credit experts, and tax professionals, to collaborate with trusts & estates and matrimonial professionals in offering a comprehensive set of services for those considering or maneuvering through divorce.

Now, we're making what we've learned available to you in this special eBook that includes insights from our experts. It includes material about the considerations that should be top of mind when clients are faced with divorce, risks they should be careful to confront, special issues for business owners and breaking tax developments in the divorce context that require immediate attention. We also include our thoughts about dividing assets that may help you inform clients of their options as they untangle joint retirement savings, make decisions about paying for college, rework estate plans, update beneficiary designations, and more.

We hope this guide serves as a valuable resource for you. We look forward to collaborating with you to support your clients in transition.

Sincerely,

Sharon Klein

Sharon L. Klein
President, Family Wealth, Eastern U.S. Region
Head of National Family Law Practice Group
Wilmington Trust, N.A.

# Part 1: Preparing for Divorce

Ending a marriage is a tremendous legal, financial, and emotional undertaking, whether it's been a long time coming, or happens suddenly. Working with your clients requires compassionate guidance on a host of matters, along with astute financial insight.

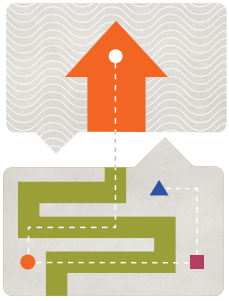
In this section, our experts at Wilmington Trust offer insights on issues we've seen clients deal with as they start down the path of divorce. We leveraged that extensive experience to compile a list of "Top 10 Considerations When Faced With Divorce." Here we highlight the importance of short- and long-term financial matters, including personal banking, college savings, estate planning, and investing. We also explore custom credit, which includes ways to secure asset-backed loans using creative collateral such as partnership interests or artwork, ideas for maintaining a current lifestyle with a potentially lower cash flow, and ways to continue charitable giving.

Blair Talty, vice president and wealth strategist at Wilmington Trust, shares "Four Divorce Risks Your Client May Not Know Exist." Divorce can derail a family's plans. He offers crucial insight about protecting family wealth for those contemplating divorce—from addressing the potential loss of generational wealth to the risk of unintended beneficiaries gaining control of prized assets. He also provides concrete solutions for each scenario.

As you prepare to represent your client, you want to lay the right groundwork, analyze a client's situation, identify potential financial risks, and foresee issues that may require proactive protection. We'll help you prepare them to face their divorce with confidence.

WEALTH PLANNING

# Top 10 Considerations When Faced with Divorce



Your best interests are our best interests. Serving the complexities that families face has been a core focus for us for more than 100 years. We can help you navigate the challenges you face today and prepare you for a new beginning, and a successful future.

The dissolution of marriage is one of the most stressful and difficult experiences you may face. At Wilmington Trust, we understand the complexities of divorce as well as the emotional strain it brings. Our goal is to not only provide the financial resources you need, but to offer trusted guidance and support from a team of advisors who put your best interests first, always.

**As you transition from one chapter of your life to the next, we can help you address these important considerations:**

**1) Have you established your own, individual banking accounts for your everyday financial needs and reviewed your new balance sheet?**
Our Private Banking* team will open accounts in your individual name. Your dedicated Private Banker will provide tailored advice and analysis of your revised assets and liabilities.

**2) Do you need financing that is customized for your unique situation?**
Custom credit can provide you with a reliable source of funding for unforeseen expenses, real estate purchases, and business investments. We'll work creatively to evaluate your options and provide lending based on your unique assets—including specialty or illiquid holdings. Solutions include:

- Bridge financing to help with a significant purchase
- Marketable securities-backed lines of credit, including restricted and concentrated stock
- Specialized asset-backed loans secured by partnership interests, fine art, yachts, and aircraft
- Residential and investment real estate financing, including lines of credit

**3) Have you projected how your settlement will sustain your lifestyle?**
Our financial planning team offers a comprehensive financial plan analyzing the changes in your cash flows from assets received, alimony received, changes in expenses, and other cash flows expected after the dissolution of marriage. By providing a comprehensive view of the following, we can help you balance your projected expenses while maintaining the lifestyle you seek:

- Cash flow planning for income and expenses
- Alimony/child support
- Asset sustainability study and portfolio risk analysis
- Tax situation review and appropriate planning

Being well-informed of all of your options is your best strategy for success. We are here to help you feel confident that you are making the right decisions for your personal situation.

**4) Have you reviewed your estate planning documents to make necessary changes?**

We will help you review all of your important estate planning documents and be certain you are providing for your chosen heirs, updating your beneficiary designations, and naming new designees for your healthcare and power of attorney documents. We also act as a central repository on behalf of our clients for all of these documents so you know that everything is organized and in one place. Documents to consider include:

- Will and trusts
- Power of attorney and healthcare directive
- Retirement accounts and plans
- Jointly named real estate and financial accounts
- Authorizations to access digital accounts, including financial accounts, email accounts, social media accounts, etc.

**5) Do you have a fiduciary you can trust to oversee your trusts and assets?**

When trusts are utilized to protect settlement payments, our experienced personal trust team provides comprehensive administration services for current and future generations. Wilmington Trust is and always has been a fiduciary when acting as trustee or as investment manager. Our first and foremost responsibility is to protect your best interests and those of your family.

**6) Is there a business valuation involved in your settlement agreement?**

The preparation of a business valuation is a lengthy and expensive process. Valuation reports can exceed one hundred pages in length and can be very difficult for even seasoned professionals to understand. For any business that has been appraised as part of the settlement process, our team can review the appraiser's valuation report and provide insights that may answer questions such as:

- Is the appraiser a qualified professional with experience and valuation credentials?
- Is the appraiser's financial analysis of the company thorough and explained?
- Are the methods used appropriate and the reasons for their selection discussed?
- Is the value conclusion reasonable, based on the factors presented in the report?

**7) Do you have the tools to set your short- and long-term investment strategies?**

If you're receiving a settlement, you want to be certain that your short- and long-term needs are met through the creation of a customized investment portfolio. Our team can tailor a portfolio based on your specific parameters, including liquidity needs, time horizon, risk tolerance, and other factors. Our differentiated investment process manages risk, maximizes tax efficiency, minimizes investment costs, and diversifies among economic exposures. Other features include:

- Personal quarterly investment reviews, tailored to your needs
- Dedicated team to oversee projected growth of portfolio, given your spending needs
- Ongoing adjustments to asset allocation to manage risk and provide adequate growth to protect against inflation

We can help you take each step carefully and thoughtfully, exploring the most appropriate options for you. Together, we'll work to create the security you need in the most sensitive and productive way.

**8) Do you need to update your insurance coverage?**

In divorce situations, insurance review is extremely important to be certain you have the appropriate coverage, you or your ex-spouse have named the correct beneficiaries, and that the premiums are being paid. We provide a detailed analysis of your health, life, disability, property & casualty, and long-term care insurance, identifying what actions might be recommended, including reviewing policy ownership and beneficiary designations, and understanding who has responsibility for premium payments.

**9) Are your children's college expenses covered?**

Our team begins with establishing projections and analytics critical to the settlement process by delineating the future costs of college based on the ages of the children and the potential colleges under consideration. This data is coupled with merit-based aid scholarship strategies and other financial aid analytics that often involve lump sum settlements and other variables that impact college funding during and after divorce. We can also recommend trust creation and execution designed specifically (or in concert with other goals) to fund education.

**10) Are you aware of the charitable techniques available to you?**

We can review any existing private foundations and charitable vehicles to be certain they are still in line with your goals and wishes. We'll also explore potential charitable techniques that could be utilized for property settlement and support payments, and as needed, charitable trusts to support philanthropy and minimize taxes.

**We will work collaboratively with your attorney and other advisors to bring you complete coordination of the key solutions you need. Please contact us to discuss your personal situation and to receive a copy of our companion guide, the *Divorce Planning Checklist*, which provides action steps to help you get started.**

# Four Divorce Risks Your Clients May Not Know Exist

Help clients take a long-term view to protect family wealth

**By Blair C. Talty**

Wealth Strategist,
Wilmington Trust, N.A.

**Key Points**

- Divorce can derail family wealth and affect generations far beyond just one couple
- Even those who are not divorcing or contemplating divorce—including those beginning prenuptial planning—could benefit from knowing what is at stake in the event of a divorce, be it their own or that of a business partner, parent, sibling, or descendant
- From a strategic planning perspective, real estate owners, investors, and developers may want to consider targeted trust strategies

**Even in the best cases, divorce is still fraught with complexity. Your clients may not be aware of all the ways a divorce could derail family wealth.**

**Even those who are not divorcing or contemplating divorce—and come your way instead for prenuptial planning—could benefit from knowing what is at stake in the event of a divorce, be it their own or that of a business partner, parent, sibling, or descendant.**

**The good news is that with some foresight and planning, these risks can be mitigated, if not sidestepped entirely.**

RISK 1:

## Unsheltered Generational Wealth Could Be Lost

When clients set up generational wealth to pass directly to their heirs, and those assets are commingled with spousal assets or used to buy marital property, they may become fair game in divorce proceedings of such heirs.

*Help clients explore:*

**Dynasty trusts**

Families do not have to rely on prenuptials to protect assets. A less emotionally charged way to shelter generational wealth is to plan its transfer using a dynasty trust with a corporate fiduciary. This way, assets intended for multigenerational use are not lost in a divorce.

Corporate fiduciaries often serve as objective and experienced trustees to help protect trust assets for the benefit of successive generations.

A collaborative team of seasoned experts can help your clients make enduring action plans. These plans can protect family wealth and make sure its transfer does not rely on the success of any current or future marriage.

**Four divorce risks your clients may not know exist**

**Help clients take a long-term view to protect family wealth**

1. Unsheltered generational wealth could be lost
2. Unintended beneficiaries could inherit or gain control
3. An ex-spouse's death could de-stabilize a family
4. Divorce could mean the demise of a family business

A multidisciplinary team of tax, legal, and wealth advisors can help clients position themselves against the many risks inherent in the case of a divorce. This guidance is especially critical when considerable assets are at stake.

RISK 2:

## Unintended Beneficiaries Could Gain Control

Failing to update fiduciary appointments, beneficiary designations, and guardianship arrangements for the care of minors—either during or in preparation for divorce—can be catastrophic.

*Help clients explore:*

**Beneficiary and fiduciary mapping**

As divorce proceedings move forward, each spouse should review and update fiduciary appointments and beneficiary designations under their wills, trusts, living wills, medical directives, and powers of attorney, as well as any insurance policies, annuity contracts, or retirement accounts.

In cases where a remarriage is on the horizon, blended families should revisit planning documents and beneficiary designations to make sure they align with the clients' collective intentions. With expert help, these families can be made aware of how estate plans can be structured so that both individually and jointly owned assets benefit a surviving spouse and successive generations. This planning vigilance is most important when there are children from prior marriages on both sides.

RISK 3:

## An Ex-Spouse's Death Could Destabilize a Family

The death of an ex-spouse can leave a devastating gap in child support, alimony, higher education costs, or other obligations that may have been negotiated in a settlement agreement or hard fought and won in a divorce proceeding.

*Help clients explore:*

**Using life insurance to secure the obligations of an ex-spouse**

Life insurance can provide funds necessary to meet an individual's post-marriage financial obligations to his or her ex-spouse in the event of such individual's untimely death. Securing sufficient life insurance can be made a part of the divorce settlement process.

An irrevocable life insurance trust, or ILIT, is designed to hold life insurance proceeds and then distribute them as directed by the trust's creator, or grantor. While they are often designed to provide a legacy for children or grandchildren in a tax-efficient manner, ILITs, in combination with other estate planning vehicles, can also be helpful in blended family situations where there are children from prior marriages and continuing financial obligations on the part of one or both divorced spouses.

RISK 4:

## Divorce Can Mean the Death of a Family Business

If one or both spouses are business owners, an inadequate buy-sell agreement or lack of liquidity could crush a business if an owner gets divorced.

*Help clients explore:*

**Comprehensive business succession planning with divorce provisions**

The best prevention is to make sure your client's business has a sound succession plan in place that includes provisions in the event of divorce.

Business partners are wise to structure business agreements to protect against the claims of an ex-spouse of one of the business partners.

If liquidity is an issue during the course of a divorce proceeding (due to a disproportionately high percentage of business or real estate holdings), access to personal credit can help satisfy the terms of a divorce settlement in a way that will not jeopardize business operations.

A multidisciplinary team of tax, legal, and wealth advisors can help clients position themselves against the many risks inherent in the case of a divorce. This guidance is especially critical when considerable assets are at stake.

**Blair C. Talty**
Wealth Strategist,
Wilmington Trust, N.A.

856.330.8012
btalty@wilmingtontrust.com

Blair develops and implements comprehensive financial, estate planning, and wealth transfer plans for high-net-worth families and entrepreneurs throughout the New Jersey region. Blair works closely with clients and their advisors to define each client's specific goals and objectives before developing an appropriate plan. Blair's areas of proficiency include estate and retirement planning, insurance planning, investment planning, education planning, business succession planning, legacy planning, and philanthropic planning. Blair holds a JD from Rutgers School of Law and a bachelor's degree in criminal justice from Rutgers University.

# Part 2: During a Divorce

You're adept at steering clients through the most challenging negotiations and considerations during an emotional time in their lives, and you want to represent their interests to the best of your ability.

As a trusted advisor, your role is to support them through all the financial aspects of divorce proceedings, and beyond. From important tax considerations to dividing a family business, this section offers information that can help you guide your clients through dilemmas that occur in the midst of a divorce.

We'll equip you with information on:

**Tax reform.** In Articles 1 and 2 in this section, Rachael Leberstien, a CPA, assistant vice president and client accounting director, writes about "Tax Return Considerations During Divorce," while Blair Talty, vice president and wealth strategist, explains how tax reform affects divorce settlements in 2019 and beyond in "The Impact of Tax Reform on Divorce."

**Retirement planning.** Article 3 features Leberstien's discussion of "The Division of Retirement Plan Assets in Divorce."

**Business valuation.** In Article 4, Karen S. Piershalski, vice president and senior closely held security analyst, shares "When Family Business Owners Get Divorced." She draws on extensive experience providing business valuation of closely held businesses for the Business Owner Advisory group, which develops wealth planning strategies for business owners.

# Tax Return Considerations During Divorce

Don't overlook this important element of divorce planning

**Rachael Leberstien, CPA**
Client Accounting Director II
Wealth Management
Wilmington Trust Company


**Key Points**

- While not typically top of mind during divorce, taxes are an important consideration
- Consult with an attorney or advisor who understands the tax laws so that planning can be done before you agree to a settlement
- Being equipped with information regarding divorce and taxes early on can help you work towards a reasonable divorce settlement agreement

**Divorce is emotionally and financially difficult and there are so many things for a divorcing couple to think about and work through. Taxes are not typically top-of-mind during this challenging time, but there are very important decisions that need to be made to be sure that tax returns are properly filed and tax liabilities are shared as required by state distribution laws.**

It's important to consult with an attorney or advisor who understands the tax laws so that planning can be done before you agree to a settlement. A tax attorney or tax accountant can review your divorce or separation agreement to determine the tax consequences of the agreement, and help plan so that you will not incur any current or deferred tax liabilities that you were unaware of when executing the divorce agreement. Your advisor will look at many tax issues from a technical standpoint but there are some basic things that will be helpful for you to know.

### Change to your filing status

Once you are divorced or separated there will likely be a change to your filing status on your tax return. So what does that mean for you? Your filing status is used to determine a number of factors on your tax return, including, but not limited to, your tax rate. A taxpayer's marital status on the last day of the tax year determines the filing status for that entire tax year. An individual will be considered to be divorced for the entire year if the divorce was finalized on or before December 31 of the tax year. A divorced individual is able to use the Single or Head of Household filing status for the tax year in which the divorce was finalized.

Going through a divorce can be a long process and in many cases a couple in the middle of a divorce is still married at the end of the tax year. Taxpayers not legally divorced or separated on December 31 are considered married for that tax year and will have the option to file their tax returns as Married Filing Jointly, Married Filing Separately, or Head of Household. The Married Filing Jointly status will usually result in a lower overall tax bill, but many individuals don't want to have to work with their spouse to get the return filed, as there may be disagreement regarding many factors that impact the return. If you are in this situation, then your next best option is the Head of Household filing status.

A taxpayer is able to file as Head of Household if the taxpayer is not married or is legally separated at the end of the tax year or the taxpayer did not live with his or her spouse for the last six months of the tax year.

The Head of Household filing status is typically more advantageous than the Single or Married Filing Separately statuses if the taxpayer has a dependent child. A taxpayer is able to file as Head of Household if the taxpayer is not married or is legally separated at the end of the tax year or the taxpayer did not live with his or her spouse for the last six months of the tax year. The taxpayer also has to have paid for more than one-half of the costs to maintain the household, and the taxpayer's child(ren) must qualify as dependents and live with the taxpayer for more than one-half of the year. All of these rules probably seem overwhelming, but it's important to know that you have options when trying to determine your filing status. Your tax advisor can work with you to determine the most advantageous filing status for your circumstances.

There are also considerations if you've been filing a return jointly with your spouse since you were married and you reported your income without having to determine what income belonged to each person. When divorcing, you need to figure that out so that each spouse reports the proper amount of income. Determining the proper allocation of income and deductions in the tax year a divorce is finalized or when a divorcing couple chooses to file separately is dependent on the distribution laws of the state where the divorce decree was or will be executed. Taxpayers in most community property states are required to equally split all community income up to the date of the divorce decree. After the divorce has been finalized, all income from that date through the end of the tax year is reported by the individual who earned it. Taxpayers divorcing in an equitable distribution state will report all income they personally earned and any income received from property they personally own.

### Understanding taxation of spousal support payments

Spousal support payments are common in divorce settlements so it's important to understand how these payments will impact your taxable income. Not all payments made from one spouse to another are considered alimony. In order for spousal support to qualify as alimony, the payments need to be made pursuant to a divorce decree or separation agreement. Payments must be made in cash, not property. The spouses may not live in the same household, they may not file a joint tax return, and there can be no requirement that payments be made to the payee after the death of the payee spouse. Prior to January 1, 2019, spousal support payments that qualified as alimony were taxable income to the payee and tax deductible to the payer.

However, the passage of the 2017 Tax Cuts and Jobs Act made significant changes to the taxation of alimony income and deductions. The effective date of the changes related to alimony was January 1, 2019, and any divorce or separation agreement instituted after that date will be governed by the new tax law, under which alimony income will not be taxable to the recipient and the tax deduction for alimony paid will be eliminated. The tax treatment of alimony for agreements entered into before January 2019 will not change after the effective date of the implementation of the tax law changes.

### Deductibility of fees

Not only is divorce difficult, but it can be very expensive. It's commonly asked whether or not any of the attorney or advisor fees incurred during a divorce are tax deductible. Unfortunately, the Tax Cuts and Jobs Act legislation repealed the deduction for legal and other professional fees for individual taxpayers. Until December 31, 2017, fees paid for tax planning and advice or to obtain taxable alimony were tax deductible. This provision of the law does sunset, meaning that as of January 1, 2026, the deduction for legal and professional fees will once again be allowed.

### Don't forget about overpayment options

There is another piece of information that is easy to overlook but has a big impact on the actual amount of tax paid. An overpayment on your prior year's tax return that has been applied to next year's estimated tax and estimated tax payments that have been paid during the tax year can be allocated between you and your spouse. The IRS allows taxpayers to allocate these payments in any agreed upon manner as long as an explanation for the allocation is attached to the tax return when it is filed. The distribution laws in your state may dictate the allocation of these payments. The payments will likely have to be allocated equally to each spouse if you are divorcing in a community property state and the tax payments were paid from community funds. The laws for equitable distribution states may require that any estimated tax payments be divided among spouses in proportion to each spouse's separate tax liability.

All of these rules can be overwhelming. However, being equipped with information regarding divorce and taxes early on can go a long way in helping you navigate these tax issues with your advisor and work towards a reasonable divorce settlement agreement.

**Rachael Leberstien**
Client Accounting Director II
Wealth Management
Wilmington Trust Company

302.651.8693
rleberstien@wilmingtontrust.com

Rachael is a director in the Family Office group, providing tax consulting and compliance services for complex individual and trust income tax returns, gift tax returns, returns for nonprofit entities and private foundations, corporate, and partnership tax returns. Rachael holds a bachelor's degree in accounting from Wilmington University where she graduated magna cum laude. She earned her CPA designation in 2005.

# The Impact of Tax Reform on Divorce

Understand the new tax treatment of alimony and other considerations

**By Blair C. Talty**

Wealth Strategist,
Wilmington Trust, N.A.

**Key Points**

- The new tax act changes the tax treatment of alimony for both the payer and the recipient
- It is important to review your settlement agreement in light of these tax law changes, and consider modification of an existing agreement if appropriate

**The Tax Cuts and Jobs Act of 2017 represents the most significant overhaul of federal tax law in over thirty years. The new tax law is sweeping in its reach, and divorce situations are not immune from its influence.**

Prior to the enactment of the new tax law, spousal support payments that qualified as alimony were characterized as taxable income to the recipient and deductible by the payer. Under the new tax law, alimony payments made pursuant to a divorce instrument finalized (or modified) after December 31, 2018 are no longer treated as taxable income to the recipient, and alimony payments cannot be deductible by the payer. The federal income tax treatment of alimony payments made pursuant to a divorce instrument finalized prior to January 1, 2019, will be grandfathered under the rules of the prior law.

Unlike many of the changes in the individual income tax provisions of the federal tax law which are set to sunset at the end of 2025, the change in federal income tax treatment of alimony is permanent, absent future legislative change.

In addition to potentially changing the manner in which property settlement agreements are reached by divorcing spouses and their advisors, the net effect of this change in the tax law is that the de facto shifting of tax brackets (i.e., lower income taxes paid) will no longer occur. Beginning with divorces finalized (or modified) on or after January 1, 2019, the presumed higher tax-bracket spouse will lose an often significant deduction, and will no longer be able to shift a portion of his or her income tax burden to the presumed lower tax-bracket spouse.

### Additional considerations

Other changes in the federal tax law will also have an impact in divorce matters and may be worth considering, either prospectively or if former spouses decide to revisit a divorce agreement already in place:

- **Personal exemption has been eliminated:**
  Before 2018, the exemption per child could only be taken by one parent. The new law eliminates personal exemptions for dependents after 2017, until the provision sunsets after 2025. If this tax benefit was part of a settlement agreement negotiated before the benefit was eliminated, impacted taxpayers should consider the effect of its elimination.

- **Limitations on/elimination of deductions (such as professional advisor fees):**
  The professional fees paid during the course of a divorce

**Divorces finalized after 12/31/18:**

**Alimony payments not treated as taxable income to recipient and not deductible by payer**

**Divorces finalized before January 1, 2019:**

**Grandfathered under rules of prior law**

Divorcing spouses and their advisors should be aware how the new tax law will impact divorce settlements moving forward.

can be substantial. The inability to deduct such fees should be factored in by divorcing parties as they negotiate the property settlement agreement.

- **Decreased corporate tax rates:** The lowering of federal income tax rates applicable to corporations could result in higher business valuations for closely held businesses, which are often a component of property settlement agreements. The higher the percentage of a divorcing couple's net worth that is represented by less liquid and harder to split business interests, the greater the strain on the more liquid assets.
- **Education expenses:** The new tax law now allows for distributions from 529 Plans to be used for qualified education expenses, not only for college, but also for tuition expenses for elementary, middle, and high school (up to $10,000 per year). Divorce instruments often address responsibility for maintaining assets for payment of education expenses. Agreements already in effect may need to be re-examined to be sure that both parents are aligned as to funding and purposes of, and distributions from, these established education accounts.
- **Child tax credit:** The annual child tax credit, which is typically available to the custodial parent, has been increased from $1,000 to $2,000. Existing divorce instruments should be reviewed to determine if the new tax law merits consideration of possible modification.

**Divorcing spouses and their advisors should be aware how the new tax law will impact divorce settlements moving forward. Further, taxpayers should review with their advisors any existing pre-nuptial, post-nuptial, and property settlement agreements, or other marital or divorce agreements, to understand the impact of the new tax law and to also consider whether possible modification under the new federal tax system is desirable and appropriate.**

**Blair C. Talty**
Wealth Strategist,
Wilmington Trust, N.A.

856.330.8012
btalty@wilmingtontrust.com

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# The Division of Retirement Plan Assets in Divorce

Don't leave money on the table or with the tax man

**Rachael Leberstien, CPA**
Client Accounting Director II
Wealth Management
Wilmington Trust Company


**Key Points**

- While you may not want to think about retirement during a divorce, retirement assets are typically one of the larger marital assets
- Determining the proper division of retirement assets in a divorce and the actual distribution of these assets is very complex
- Each type of retirement asset must be handled in a different manner, so it's important to consult with your tax advisor


**Divorcing individuals may not want to think about retirement when they are negotiating the division of their marital estate, but retirement assets are typically one of the larger marital assets. The proper division of these assets in divorce is extremely important to the financial future of each spouse.**

Retirement assets include those assets held in workplace retirement plans as well as traditional IRAs and Roth IRAs. Transferring retirement plan assets from one spouse to another is complicated due to the strict rules that govern the distribution of assets from any qualified plan or IRA. It's important to work with a qualified professional who has experience in the transfer of assets from qualified plans and IRAs. Retirement assets that are incorrectly transferred could be considered a full distribution of those assets and could incur considerable tax liabilities. The tax consequences can be severe: the distribution amount could be fully taxable as ordinary income and a 10% penalty could be assessed if the recipient is younger than 59 ½ years old, in addition to the regular tax.

### What type of retirement assets are involved?

The first step is to determine what type of retirement assets are held by each spouse. This is necessary because the tax characteristics of retirement assets can differ, as well as the rules governing the transfer of those assets. Put all "qualified plan" assets into one bucket and all IRAs into another bucket to start. Qualified plan assets originate from employer-sponsored plans and include 401(k)s, 403(b)s, and pension plans. From there, you can determine if there are Roth 401(k) assets as part of your qualified plan assets or Roth IRA assets

as part of your IRAs. The Roth 401(k) and Roth IRA assets are after-tax savings vehicles so withdrawals from these accounts after the owner reaches the age of 59 ½ are not taxable to the owner. Ignoring the tax implications of withdrawals from each retirement asset could be a serious mistake. The non-Roth assets are pre-tax accounts and any distributions from these accounts in retirement will be subject to tax. Once the determination has been made regarding the type of asset and its taxability, negotiations can begin to determine a fair settlement.

### Division of retirement assets

The divorce decree or property settlement agreement is an instrument that outlines the division of the assets to each spouse and there could be language in the instrument that specifically addresses the retirement assets. Many people think the divorce decree or property settlement agreement can be used to divide all of these assets but it can only be used to govern the division of assets held in a traditional IRA or Roth IRA. The inclusion of language in the divorce decree or property settlement agreement requiring the transfer of retirement assets in a workplace retirement plan is not sufficient to cover a spouse's rights to the assets. The division of retirement plan assets must be handled through a qualified domestic relations order, commonly known as a QDRO. A QDRO is needed to protect the interests of each spouse. Any transfer from a qualified plan pursuant to a divorce decree that is not deemed a QDRO is subject to tax and could be subject to penalty, and the transferor will be responsible for payment of the applicable taxes and penalties.

### Terms of the QDRO

According to the Employee Retirement Income Security Act of 1974 (ERISA), a QDRO is a judgment, decree, or court order that creates or recognizes the existence of an alternate payee's right to receive all or a portion of a plan participant's benefits under an ERISA-qualified employee benefit plan. QDROs generally apply only to retirement assets held in workplace plans such as 401(k)s, 403(b)s, or traditional pension plans. Each QDRO must conform to specific rules determined by the plan administrator and no two QDROs are alike. A separate QDRO must be written for each plan that is to be divided or transferred. The plan administrator must approve the QDRO before the alternate payee is given any rights to the retirement account. The approval process is lengthy and it should be completed before the divorce is finalized. Once the QDRO is approved, the receiving spouse may roll QDRO assets into his or her own qualified plan or into a traditional IRA or Roth IRA. Be aware that a transfer of non-Roth assets into a Roth IRA will be taxable as a conversion but the transfer is not subject to an early withdrawal penalty.

## What is a QDRO?

A QDRO, or qualified domestic relations order, is a judgment, decree, or order for a retirement plan to pay child support, alimony, or marital property rights to a spouse, former spouse, child, or other dependent of a participant.

### Transferring a traditional or Roth IRA

The transfer or assignment of traditional IRA and Roth IRA assets are handled in a different manner, as these assets are not subject to ERISA rules. IRAs can be divided using a process known as "transfer incident to divorce" or through a domestic relations order. A "transfer incident to divorce" is commonly done through a custodian to custodian transfer and there are no tax consequences as a result of the transfer, provided the transfer was specifically required in the divorce decree or a property settlement agreement that is incident to the divorce decree. Any other transfers pertaining to separation or temporary support will result in a taxable transfer. While a domestic relations order is not required to transfer or divide a traditional IRA or Roth IRA, the use of a domestic relations order is recommended to give additional protection and ensure the avoidance of taxation on the transfer of the assets to the spouse.

It's important to understand that unlike the QDRO process with the qualified plans, IRA assets cannot be transferred or divided until after the divorce decree or property settlement agreement has been entered. The timing of any transfer of

**Division based on percentages protects against market fluctuations**

**Dividing by percentages**

If your IRA is worth: $300,000

*Agreement:*
*50% to your spouse*
*50% to you*

The market drops
and your IRA is now worth: $200,000

**50% to your spouse: $100,000**
**50% to you: $100,000**

**Dividing by dollar amounts**

If your IRA is worth: $300,000

*Agreement:*
*$150,000 to your spouse*
*$150,000 to you*

The market drops
and your IRA is now worth: $200,000

**$150,000 to your spouse**
**Only $50,000 to you**

IRA assets is crucial. If the assets are transferred before the divorce is final and the original owner is younger than 59 ½, he or she may be subject to income tax on the distribution amount and a 10% early withdrawal penalty will be assessed. Once the transfer is complete, the recipient of the IRA assets will take legal ownership of the assets then assume sole total responsibility for the tax consequences of any future transactions or distributions. At this time the IRA owner will be subject to the normal distribution rules, which specify that distributions to the IRA owner aged 59 ½ or older are not subject to the 10% early withdrawal penalty. Distributions to the IRA owner younger than 59 ½ are subject to the 10% early withdrawal penalty unless the recipient qualifies for one of the exceptions to the penalty.

### Beware of pitfalls when transferring assets before the divorce is final

There are some potential pitfalls that you should be aware of before assets are transferred and the divorce is finalized. First, it's important that the division of assets is determined based on a percentage of assets instead of a set dollar amount. The use of percentages will protect against market fluctuations and clarify the amounts to be received in the agreement. If set amounts are used in the agreement and the value of the assets increase or decrease based on the market, neither spouse is protected from the fluctuations. For example, suppose your IRA is worth about $300,000 when the divorce decree is signed and your spouse is to receive $150,000 of the IRA. The day before the transfer is made to your spouse, the market declines and your IRA is now worth $200,000. Based on the divorce decree or property settlement agreement, $150,000 will still be transferred to your spouse. Had the divorce decree been written to state that your spouse was to receive 50% of the assets in your IRA account, then your spouse would receive $100,000 when the transfer is made.

Another example illustrates the impact based on the increase in the value of assets. Suppose in this scenario that your spouse has an IRA worth $800,000 and the divorce decree or property settlement agreement states that you are to receive $400,000 of the IRA. A few days after the agreement is executed and before the funds are transferred, there is an increase of $200,000 in the fair market value of the IRA, so now the total value of the IRA is $1,000,000. Based on the agreement you will receive $400,000 regardless of the value on the date of the transfer of the IRA asset. You have now lost out on the increase in value due to the market fluctuation. If the divorce decree or property settlement agreement had used percentages instead of a fixed dollar amount, then you would have received $500,000 upon the transfer of the IRA. The use of percentages will help to mitigate any risk of your spouse getting an unequal amount of assets.

Next, determine the basis of any retirement plan or IRA assets held so that the basis is properly transferred upon the distribution of the retirement plan or IRA assets to the receiving spouse. The basis can be determined by how the contribution was reported for tax purposes. It's possible that nondeductible contributions were made to an IRA in prior tax years and there is basis in those contributions. Be sure to check your tax returns filed for Form 8606 and consult a tax advisor if nondeductible IRA contributions were reported.

### Update your beneficiary designations

Finally, make sure to add or update your beneficiary designations on all retirement accounts to be sure that the intended recipients receive the assets upon your death, not your ex-spouse. Beneficiary designations are specific to each retirement account held so a separate designation should be completed for any account you hold. The distribution of retirement plan assets, whether held in a qualified plan or IRA, is not governed by your will, which makes it extremely important to review your beneficiary designations for each account upon executing a divorce. Be aware that due to ERISA's "spousal consent rule," the beneficiary designated on your qualified retirement plan accounts must be your spouse unless your spouse gives written consent allowing a non-spouse beneficiary to be named; therefore, you will likely have to wait until the divorce is executed before changing the beneficiary. Traditional IRAs and Roth IRAs are not subject to the ERISA rules and the beneficiary can be changed by the account owner at any time by completing the proper forms provided by the custodian.

**Determining the proper division of retirement assets in a divorce and the actual distribution of these assets is very complex. Protect yourself and your financial future by working with a qualified advisor who can help you navigate the intricacies of the division of retirement plan assets.**

**Rachael Leberstien**
Client Accounting Director II
Wealth Management
Wilmington Trust Company

302.651.8693
rleberstien@wilmingtontrust.com

Rachael is a director in the Family Office group, providing tax consulting and compliance services for complex individual and trust income tax returns, gift tax returns, returns for nonprofit entities and private foundations, corporate, and partnership tax returns. Rachael holds a bachelor's degree in accounting from Wilmington University where she graduated magna cum laude. She earned her CPA designation in 2005.

# When Family Business Owners Get Divorced

## Valuation is key to the equitable distribution of your business

**By Karen Piershalski, ASA**
Senior Closely Held Security Analyst,
Wilmington Trust, N.A.


**Key Points**

- The inclusion of a family business in your divorce proceedings can make things a bit more complicated
- Selling the business and splitting the assets, or one spouse buying out the other, are two options to consider
- When a buyout is involved, it requires a business appraisal as well as a strategy to fund the buyout

**Navigating the emotional and financial challenges of a divorce can be daunting enough. But when a family business is part of the divorce proceedings, there are additional decisions to be made to determine the future of the business and the equitable distribution of its assets.**

If only one spouse is involved in the business and will continue to operate it as such, then an appraisal of the business will be needed to determine its value for purposes of buying out the non-operating spouse. When combined with the balance of the marital assets, this valuation will provide the basis for an equitable settlement.

However, when both spouses are involved in running the business, other factors need to be considered. Can you continue to work together for your mutual financial well-being and to preserve the business? If not, two choices remain: 1) Sell the business and split the proceeds, or 2) One spouse buys-out the other. As noted above, a buyout requires a business appraisal, as well as a strategy to fund the buyout. Seldom do businesses have sufficient cash available to fund the buyout, so the substitution of other marital assets may provide a better alternative to financing a sale.

### Selecting a business appraiser

Business appraisers are retained in matrimonial matters through court appointment; jointly with consent of both you and your spouse; or privately retained with the help of your attorney. Each method has benefits and drawbacks. Privately retained experts can assist in negotiations and advise on tax and accounting issues. Court appointed and jointly retained experts must remain neutral and should not assist either side with negotiations or litigation.

Choosing the right business appraiser or valuation firm is an important decision. There are several business valuation designations that an individual can earn that signify basic knowledge in business appraisal. Organizations granting designations have their own accreditation requirements. In cases of unreported business income, the Certified in Financial Forensics (CFF) designation, offered through the American Institute of Certified Public Accountants (AICPA), has a focus on forensic analysis. The Accredited Senior Appraiser (ASA) and Accredited in Business Valuation (ABV) designations offered by the American Society of Appraisers and AICPA, respectively, are specific to valuation of closely held businesses. Chartered Financial Analyst (CFA) designations are more geared to public company security analysis. Court experience is important as well. Look for one or more of these designations along with expert witness experience to select the most qualified appraiser.

### Selecting a business appraiser

**There are several business valuation designations that an individual can earn that signify basic knowledge in business appraisal. Some designations include:**

- Certified in Financial Forensics (CFF)
- Accredited Senior Appraiser (ASA)
- Accredited in Business Valuation (ABV)
- Chartered Financial Analyst (CFA)

### Determining the value of the business

There are three approaches to determine the value of a business: the income approach; the market approach; and an asset-based approach. They are not mutually exclusive and a comprehensive analysis should consider each method and detail why it may or may not be appropriate given the circumstance. The income method requires the estimation of future income and conversion to value using a discount or capitalization rate appropriate given the level of risk of achieving expected returns. The market approach is based on the principle of substitution. Comparable private company sale transactions or stock prices of publicly traded companies can be used to capitalize the returns of the company being valued. The asset-based approach focuses on the balance sheet and deriving a value through the hypothetical sale of the assets.

A business appraiser will also take other factors into consideration including employment agreements, operating agreements, and shareholder agreements. Contracts between the shareholders often offer the best indication of the value of the subject interest. But, while binding parties to the agreement, the court is free to consider other factors when determining value in the context of divorce.

### Shareholder loans and personal guarantees

Does your family business have shareholder loans on the balance sheet? Shareholder loans are personal assets includable in the marital estate, so they will need to be valued along with the family business. Shareholder loans are typically not worth their face value or unpaid balance. They are a contract to repay a debt in the future under specified terms. The amount and timing of the future payments as well as the current interest rate environment, strength of the borrower, and underlying collateral must all be taken into consideration before determining an estimated value. However, what if the shareholder loans are not really loans at all but capital contributions in disguise? There is considerable ambiguity regarding whether shareholder-level discounts are appropriate in business valuations prepared for divorce purposes across state lines. Therefore, the reclassification of shareholder debt as equity can result in discounts and the loss of marital asset value.

Many questions need to be answered when classifying shareholder notes as debt or equity. They include:

- Has the obligation been formalized in writing?
- Is repayment unconditional with a fixed repayment schedule and reasonable interest rate?
- Is the loan collateralized and does it include default provisions?

- Does the company generate sufficient cash flow to repay debt obligations?
- Are the shareholder loans subordinated to other sources of debt financing?

These factors are not exhaustive, and the absence of one or more consideration would not necessarily result in a reclassification, but help to determine the intent of the party making the loan.

Personal guarantees are more often than not required to obtain bank financing for small and mid-sized businesses. In some instances, debt is only extended because of the personal guarantee or pledge of personal assets. It's important to recognize what effect not having the personal guarantee and/or personal collateral would have when valuing the company. Typically, the higher the cost to borrow, the lower the value of the business. These are just a few of the many complicated issues your attorney and business appraiser will address on your behalf.

**While the inclusion of a family business in your divorce proceedings can make things a bit more complicated, working closely with your advisors and business appraiser will help you make the most informed decisions as you embark on this new chapter of your life.**

**Karen Piershalski, ASA**
Senior Closely Held Security Analyst, Wilmington Trust, N.A.

716.848.3161
kspiershalski@mtb.com

Karen is responsible for providing business valuation of closely held businesses for the Business Owner Advisory group, which develops wealth planning strategies for business owners. She also values ESOP plans and capital transactions and provides an annual review of closely held assets held in trust accounts. She has been engaged exclusively as a professional business appraiser since earning her ASA designation, and has experience across a wide variety of industries including cyber security, healthcare, manufacturing, construction, wholesale, and retail businesses. Karen holds a bachelor's degree in accounting from the State University of New York (SUNY) at Buffalo.

# Part 3: The Aftermath of Divorce

After the divorce is final, you still have work to do on behalf of your client. This section looks at two issues our financial professionals encounter regularly with clients who've been through divorce.

**Establishing credit.** Some ex-spouses find themselves without a strong financial footprint after years of relying on a spouse for building strong credit ratings. They're forced to write a new financial chapter on their own. In Article 1, "How to Build Credit After Divorce," Anne St. Clair, CIMA, Private Banking regional managing director, shares insights that can help you offer clients valuable guidance.

**College tuition planning.** In Article 2, Jerry Inglet, director, Education Advisory Services, takes a close look at college savings planning in "Planning for Higher Education in Divorce." The first part of the article focuses on planning that should occur as the divorce is happening, but it also examines issues that occur years later. Learn strategies for mitigating any negative effects related to who owns college investment accounts and how that could affect financial aid, even among high-net-worth families. You'll also get guidance on how to fill out financial aid forms for your client's best advantage.

**Marital agreement alert.** In Article 3, "Change in Taxation of Trust Income Following Divorce Requires Immediate Attention," Sharon Klein, president of Family Wealth for the Eastern U.S. Region, alerts advisors that, in light of recent tax law changes, the tax impact of every trust created during a marriage should be carefully considered when negotiating a divorce settlement, or presenting the evidence to a court. As Sharon advises, trusts created during a marriage can have adverse tax consequences long after the divorce is final, so it's important to explore all the options.

# How to Build Credit After Divorce

Gain the confidence and direction you need to succeed in your new life

**Anne St. Clair**
Regional Managing Director
Private Banking
Wilmington Trust, N.A.

**Key Points**

- Realizing your credit record and score isn't quite what it was when you were one-half of a married couple can be very distressing
- Even if you received a lump sum settlement, you may still need to show prospective lenders that you are a reliable borrower
- There are several steps you can take to build or rebuild credit and keep from making the kind of missteps that can be hazardous to your wealth


**For better or worse, you're entering a new chapter in your personal and financial life after divorce. If you weren't the primary breadwinner in the marriage, you may have relied on your partner to handle the finances. Starting anew, many in your situation face a rude awakening when they realize their credit record and score isn't quite what it was when they were one-half of a married couple.**

Lenders and insurers will typically consider applicants with poor credit to be higher risks and, as a result, may offer them higher mortgage and credit card interest rates, as well as insurance premiums. But take heart—here are some simple ways to build or rebuild credit and keep from making the kind of missteps that can be hazardous to your wealth.

### Order and carefully review copies of your credit reports

Go to http://www.annualcreditreport.com to order free copies of reports from the three major credit bureaus and find out what they know about you that could be keeping your credit from being less than pristine. First, look for low-hanging fruit in the form of damaging errors, such as credit limits or balances that are not accurately reflected. If you find a mistake, follow the instructions that came with your credit report to have it amended. After the matter is resolved, you should receive a notification of the correction with the amended report.

Keep in mind that while you may no longer be married to your spouse, you are forever bound in the databases of creditors as long as you have shared debt. Until a creditor releases you, or a determination is made that severs your responsibility on a debt, you can be held responsible for the debt. Stay on top of your payments because if your ex goes over a credit

What's in a name? If you're a divorced person going back to your family name, wait until it's court-approved before applying for credit in your new (old) name. Be sure to contact existing creditors to let them know of the name change. Know that changing your name doesn't give you a clean credit slate. While your credit history is tied to your name, it's also tied to your Social Security number.

limit or doesn't make timely payments, creditors still have the right to come after you, and a non or late payment could cause a lingering black mark on your record. Once the debt responsibilities have been divided in the divorce pursuant to a property settlement agreement, close joint accounts and have your name removed as an authorized user. All of this should be properly reflected in your credit report.

### Begin to give yourself some (solo) credit

Lenders want to see that you're a good credit risk, meaning that you are a responsible borrower who makes prompt, regular payments. If you and your ex enjoyed good credit and you were an authorized user on credit cards, you should probably not have a difficult time applying for a credit card and should call to see if you qualify for a card in your own name.

However, if you didn't have good joint credit and your income won't qualify you as a good risk from a lender's perspective, making a fresh credit start may require a little effort. Consider:

- A "secured" credit card. This involves your providing funds to the card issuer in exchange for the ability to charge up to a low credit limit, which is a percentage of the secured amount.
- Department store charge card. These are generally easier to obtain than standard credit cards.
- A bank loan. Perhaps you may qualify for an unsecured loan; if not, a loan that is secured with collateral (such as a bank account or other asset received in the divorce that the issuer can seize in case you can't make the payments).

Gradually, once lenders see that you are a responsible payer and a good risk, you'll be able to spread your wings among traditional credit cards, mortgages, credit lines, and other types of loans.

**Even if you received a lump sum settlement, you may still need to show prospective lenders that you are a reliable borrower. Even repaying a loan that is collateralized with your portfolio's securities can help lenders to see you as a good risk and be a prudent way to create as-needed liquidity.**

### Know the score

Virtually all prospective lenders are guided by your credit score—a numerical compilation of factors, such as payment history, credit lines, debt owed, etc., that is a marker for creditworthiness. Your score is the single-greatest factor in determining how likely it is that you will qualify for the lowest debt interest rates and insurance premiums. Scores may also often be considered by prospective landlords and employers.

The Fair Isaac Corporation, developer of the well-known "FICO" risk-assessment score, has credit categorizes that range from 780–850 (low risk) all the way down to 620 and below (high-risk or "sub-prime"). You can obtain your FICO score at no cost at www.freecreditscore.com. If yours isn't in the highest or even second-highest rung, there is a lot you can do—or not do—to attain and not lose your financial footing. Here are some key factors that go into a credit score:

- On-time payment record. Timeliness counts for about 35% of your credit score, since past missed payments are often an indication of future missed payments. One delinquency could echo for seven years and cost you up to 100 score points.
- Your debt-to-credit-limit ratio. The amount of debt relative to your total available credit comes to roughly 30% of your credit score. For credit cards, it's best to not let your balance rise above the halfway mark on any one card's credit limit.
- Open credit lines. It helps to keep the balance-to-limit ratio low. There's really no upside to closing a line of credit since untapped credit will improve your ratio.
- Length of credit history. The older your credit lines and accounts, the more you have shown yourself to be a good risk and lending prospect.
- Sudden burst of new accounts. This can make lenders and credit card issuers jittery, as it may appear that you are either on a spending spree, unable to pay your bills, or both. It's of particular concern with revolving debt accounts such as a credit card (versus a fixed or installment loan, like a mortgage), where each payment frees up more borrowing potential.

**Taking the steps above should go a long way toward helping you become the kind of risk that lenders seek. Remember, though, that while you may currently be focused on creating a credit transformation to assert financial independence, credit is just one piece of your overall wealth picture. Only an integrated, comprehensive financial plan can help identify and track progress toward all of your financial goals—credit and otherwise—and provide the confidence and direction you will need to succeed in your new life.**

**Anne St. Clair**
Regional Managing Director
Private Banking
Wilmington Trust, N.A.

732.476.6133
astclair@wilmingtontrust.com

Anne is responsible for meeting the complex financial needs of Family Wealth's National and Delaware clients. She provides strategic advice, highly personalized service, and access to banking and advisory lending solutions fulfilled through M&T Bank, including bridge financing, residential and investment real estate financing, and specialized asset-backed facilities secured by investments, art, yachts, and aircraft. Anne holds a master's degree in finance and management from Tulane's Freeman School of Business and a bachelor's degree from the University of Colorado.

# Planning for Higher Education in Divorce

## Don't let college planning become an afterthought

**Dr. Jerry Inglet**

Director, Education Advisory Services
Wilmington Trust, N.A.

### Key Points

- Nearly half of all U.S. children will experience the breakup of their parent's marriage and many the failure of a second marriage as well.
- Divorce is an emotionally charged life event that may cause many to leave college planning as an afterthought.
- High-net-worth families are not immune from the challenges of funding college and completing financial aid forms properly.


**Certain metrics on divorce in the United States are widely known. It is common knowledge that half of all marriages fail. But a deeper examination of Census data reveals that 41 percent of first marriages end in divorce while 60 percent of second-time nuptials and 73 percent of third marriages do not last. The average age of a divorcing party during their first marriage is 30 years, an age where children are often in the picture.**

Nearly half of all U.S. children will experience the breakup of their parent's marriage. In addition, half of these very same children will endure the failure of a parent's second marriage. Although recent trends demonstrate that divorce rates are improving, there are many complexities that result from these breakups; among them are the funding of college and the challenges of completing financial aid forms properly as a divorced family.

High-net-worth families are not immune from these concerns.

### Specifying college funding in the divorce decree

In cases where college funding is either voluntarily provided or issued as a result of a court or state mandate, a quality practice for high-net-worth families is the completion of a divorce decree or property settlement agreement that includes understandable terms of college costs. These agreements should include specific financial responsibilities for both parties in an effort to reduce confusion during the college years. More specifically, funding that defines tuition, room and board, books, and miscellaneous fees at a detailed level is critical to creating a clear expectation as part of the divorce proceedings. Challenges arise when the decree or property settlement agreement are not specific enough in regard to the expenses, such as identifying the institution type (private or public schools) and the level of collegiate pursuit to be funded (undergraduate only, up to masters, or through doctoral study). It's also important to account for inflation increases and future cost projections for any of these types and levels of college costs; this can be done by reviewing historic inflation data on tuition, fees, and room and board through the U.S. Department of Education.

41% of **first** marriages end in divorce

60% of **second** marriages end in divorce

73% of **third** marriages end in divorce

### Investment and trust considerations

The specific investment vehicles utilized and the titling and protection of assets are important planning considerations as well when defining costs. You should also be aware of other family members who have contributed to your children's college funding so that the goals and mandates connected with college are not over or under funded. All of these variables can play a role and may have consequences on taxes, gifting strategies, and possibly financial aid.

To complicate matters further, high-net-worth families with minor children often have existing investment accounts designated for college at the time of the divorce. The ownership of these accounts, post divorce, could possibly have a financial aid impact on the student if the custodial parent will have a significantly lower income as compared to the non-custodial spouse. Before ownership on the existing investments is established within the decree or property settlement agreement, utilizing various college net price calculators is an important practice. Using the net price calculators will provide insight if the custodial parent will have any possibility of greater financial aid access in cases where he or she may either maintain or expunge ownership of the already established asset. Additionally, if there is a significant income disparity between the divorcing parties, consideration of a 51/49% custody split in favor of the lower-income parent could be favorable if joint custody is desired and financial aid maximization is a goal. Some colleges will use only the income of the custodial parent for their financial aid calculations.

Not only are there a variety of investment vehicles and considerations for existing and future investments, some families entertain the possibility of setting up a trust to fund education for existing and sometimes future generations. Trusts can be established in many different formats. Some trusts can be general in nature while others can be more restrictive, with specific parameters as to how the funds can be used for educational expenses. The type of trust and the state in which it is located and administered require careful consideration and should be discussed with an advisor to determine the strategy that is best for your family's particular situation.

### Filling out forms: Financial and merit-based awards

Moving forward to the college years, many high-net-worth divorced families will need to complete the Free Application for Federal Student Aid (FAFSA) and the College Scholarship Service (CSS) Profile even if they will not receive any need-based aid. Both the FAFSA and CSS Profile are financial aid forms that gather various pieces of information, including income and assets, and serve as the driver for need-based financial aid consideration and merit-based aid, respectively. All accredited colleges utilize the FAFSA and several hundred colleges use both the FAFSA and CSS Profile as the data portals that generate both need-based and merit-based award letters.

The two forms have variances when addressing families of divorce. More specifically, the FAFSA will only require that the custodial parent and student fill out the FAFSA. The income and the assets of the non-custodial parent are not included in the data entered by the custodial parent but any child support and/or alimony received by the custodial parent is submitted. For the purposes of the FAFSA, the custodial parent is defined

Sometimes life's circumstances do not neatly fit into a box on either the FAFSA or CSS—especially in the cases when a divorce is not complete and child custody is in flux.

as the parent with whom the child has resided most over the past 12 months as of the date of the FAFSA submission. If the custodial parent is remarried, the new spouse will be included on the FAFSA submission (even if there is a pre-nuptial agreement in place). Sometimes life's circumstances do not neatly fit into a box on either the FAFSA or CSS—especially in the cases when a divorce is not complete and child custody is in flux. For these cases and questions, the parent should contact the financial aid department at the colleges under consideration for guidance and professional judgment.

The CSS Profile asks for more details than the FAFSA, and it also asks for the information from both the custodial and non-custodial parent (and their spouses if remarried). On the occasion that a non-custodial parent refuses to cooperate and complete the CSS Profile, the custodial parent can contact the financial aid department for guidance on how to proceed. Mandatory cooperation by both parents should also be required in the property settlement agreement or divorce decree.

**Moments of divorce are often emotionally charged life events that many times leave college planning as an afterthought. To avoid the pitfalls of the afterthought, a quality divorce decree or property settlement agreement that addresses college funding in concert with an understanding of the financial aid process can go a long way to setting a child up for success during the college years.**

**Dr. Jerry Inglet**
Director, Education Advisory Services
Wilmington Trust, N.A.

716.316.4888
ginglet@mtb.com

As the lead contact and developer for Wilmington Trust's Education Advisory Services, Jerry works to provide research-based information to parents of potential college students that is centered on the financial cautions and concerns of choosing and paying for college. Jerry has more than seventeen years of banking and finance experience. He holds a EdD. in educational leadership and administration from D'Youville College; two master's degrees from SUNY Buffalo in urban policy and school counseling; and a bachelor's degree as a University Scholar from Xavier University.

# Marital Agreement Alert:

## Change in Taxation of Trust Income Following Divorce Requires Immediate Attention

**By Sharon L. Klein**
Head of National Family
Law Practice Group
Wilmington Trust, N.A.

### Trusts created during a marriage can have adverse tax consequences long after divorce

#### Grantor trusts

Any individual can create irrevocable trusts for the benefit of family members, moving the assets transferred to those trusts out of the trust creator's estate for estate tax purposes. The trust creator is also known as the "grantor." Even though the assets may have been irrevocably gifted to the trusts, it is possible for the grantor to remain responsible for paying the trusts' income and capital gains taxes. These trusts, which are treated as owned by the grantor for income tax purposes, are known as "grantor trusts." The income from these grantor trusts is taxed to the grantor, even though s/he no longer owns the assets, and the trust income is actually distributed to other beneficiaries. This is a very popular estate planning tool because, although the grantor's payment of the trust's tax liability has no gift tax consequence, in effect, it allows the grantor to make gifts to the trust in the amount of the income tax payment, which otherwise would be payable by the trust or trust beneficiaries. Accordingly, practitioners often purposely include provisions in trusts that will trigger grantor trust status, allowing these trusts effectively to grow tax-free for the beneficiaries.

#### Grantor trust status remains after divorce

Additionally, under Internal Revenue Code (IRC) § 677(a)(1), a grantor is treated as the owner of any portion of a trust if income may be distributed to the grantor or the grantor's spouse. Under IRC § 672(e)(1), a grantor is treated as holding any power or interest held by an individual who was the grantor's spouse at the time the power or interest was created. Accordingly, if a trust was created while the parties were married and trust income may have been distributed to the grantor's spouse, that trust likely will be a grantor trust *and will remain a grantor trust even if the grantor and the grantor's spouse subsequently divorce*. In other words, after a divorce, the grantor would be liable to pay the taxes attributable to trust income that was paid to the grantor's ex-spouse, and the ex-spouse would receive the income tax-free. Until December 31, 2018, IRC § 682 prevented that result by providing that the income distributed to a spouse after a divorce is taxable to the recipient and not the grantor. That protection has ended. The Tax Cuts and Jobs Act (the Tax Act), signed into law on December 22, 2017, repeals § 682 for divorce or separation agreements executed after December 31, 2018.

The Tax Act changes regarding the repeal of IRC § 682 are permanent, and do not sunset.

### All trusts created during the marriage are potentially affected

Note that the effective date of the repeal is keyed to the date the divorce or separation agreement is signed, not the date a trust was executed. This means that, beginning this year, if a couple gets divorced and one spouse created a trust at any point during the course of the marriage from which the other spouse could receive income, that trust generally will be a grantor trust and the spouse who created the trust will continue to be liable to pay the taxes on all future distributions received by his/her ex-spouse! This will affect some of the staple techniques of marital estate planning, such as the lifetime marital trust and the popular Spousal Limited Access Trust (SLAT).

## What Should You Do?

Collaboration between estate and matrimonial attorneys will be key in investigating any techniques that potentially could change grantor trust status. In doing so, it will be important to be mindful of possible adverse tax consequences, for example, in jeopardizing a trust that previously was created without a gift tax consequence because it qualified for the marital deduction. With that caveat, possibilities might include terminating the trust upon divorce, "decanting" the trust to a new trust or otherwise modifying the trust in favor of other beneficiaries, and in any of those scenarios equalizing with other assets. Perhaps the best solution might be to include a reimbursement provision or other equalization mechanism in a separation agreement for the taxes that will continue to payable by the grantor spouse.

**The bottom line:** The tax impact of every trust created during the marriage should be carefully considered when negotiating a divorce settlement, or presenting the evidence to a court.

**Sharon L. Klein**
Head of the National
Family Law Practice Group

212.415.0531
sklein@wilmingtontrust.com

Sharon is president of Family Wealth, Eastern Region, for Wilmington Trust, N.A. She is responsible for coordinating the delivery of all Wealth Management services by teams of professionals, including planning, trust, investment management, family office, and private banking experts, to high-net-worth clients in the Eastern United States. Sharon has more than 25 years of experience in the wealth management arena and is a nationally recognized speaker and author. She holds a master of laws from the Boalt Hall School of Law at the University of California, Berkeley, and received a bachelor of arts and a bachelor of laws from the University of New South Wales, Australia.

# Collaboration Is Key

We hope you've gained valuable insights from reading the collective guidance from our Wilmington Trust team leaders. With our knowledge and extensive experience, we've helped many clients navigate the challenges of divorce, and we appreciate the opportunity this eBook provides to help you support your clients through divorce and beyond.

Our goal in each chapter has been to make it a little easier for you and your clients to plan through the divorce process, and life afterwards. We can provide education, support and advice on a wide range of topics including generating cash flow, maintaining a standard of living, achieving philanthropic giving goals, and more. We're always here to answer any questions you might have.

**The Wilmington Trust team.** Our team members can answer questions your clients may have about qualifications to look for in selecting trustees and how settlement proceeds can be invested to achieve goals. We're happy to pass our ideas to you.

**Private Banking group.** From new bank accounts and credit cards to custom credit and real estate loans, we have experience helping those going through a divorce to establish their own financial profiles. We can talk you through scenarios your client may be facing.

**Philanthropic Planning team.** From examining charitable vehicles prior to their division in divorce to helping your client use savvy giving practices that could minimize taxes afterward, we can provide guidance to help clients make well-thought-out decisions.

Our goal is to support your efforts to achieve an optimal outcome for the clients you represent. Learn more about our Divorce Advisory Services. We look forward to partnering with you.

Our **Divorce Insights** collection was truly a collaborative effort by members of our planning, trust, marketing, and communications teams. Thought leadership is a key component of the holistic planning services provided at Wilmington Trust.

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**Authors:**

- Dr. Jerry Inglet
- Rachael Leberstien
- Karen Piershalski
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- Blair C. Talty

**Marketing & Communications:**

- Marketing—Laura Cleveland, Andrea Spahr, and Shraddha Walter
- Communications—Kristen Wood

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